Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

June 30, 2017

Overview

The composite generated a 1.4% return for the second quarter, compared to a 2.5% return for the Russell 2000 Index and a 0.7% return for the Russell 2000 Value Index. For the first six months of the year, the composite increased 2.2%, while the Russell 2000 Index rose 5.0% and the Russell 2000 Value Index increased 0.5%. During the second quarter, most sectors of the small cap markets rose, although commodity-oriented and consumer staples stocks were weak. Trends were more mixed for the first half of the year, with financials posting negative returns along with the sectors that performed poorly in the second quarter.

The composite underperformed the Russell 2000 Index during the second quarter and first six months of the year, but outperformed the Russell 2000 Value Index during both periods. Growth stocks significantly outperformed value stocks during both time frames. When that occurs, the composite typically performs better against the value index than it does the core Russell 2000 Index.

The risk/reward for equities remains in balance. The outlook for earnings continues to be favorable and if companies deliver as expected, stock prices should respond positively. However, valuations are towards the higher end of their historical range, creating risk to the downside if earnings fail to meet expectations.

Market Review

Stocks rose during the second quarter, as indicated by the Russell 2000 Index's 2.5% increase, the 0.7% return generated by the Russell 2000 Value Index, and the S&P 500 Index's 3.1% increase. The solid second quarter performance helped drive year-to-date gains of 5.0% for the Russell 2000 Index, 0.5% for the Russell 2000 Value Index, and 9.3% for the S&P 500 Index.

Stock price gains were fairly broad-based during the second quarter and year to date, with most sectors generating positive returns. Bucking the trend were commodity-oriented sectors, which responded negatively to lower oil prices. In addition, consumer staples stocks declined in part due to fears that Amazon's announced acquisition of Whole Foods Markets would pressure profits for grocery retailers and their suppliers. Financial stocks posted modest gains in the second quarter, but were down for the first six months of the year as they gave back some of their strong post-election gains.

Small cap growth stocks significantly outperformed small cap value stocks during the second quarter and first six months of the year, as indicated by the Russell 2000 Growth Index's 4.4% quarter and 10.0% year-to-date gains and the Russell 2000 Value Index's 0.7%

and 0.5% gains over the same time frames. Healthcare stocks, biotech in particular, were among the best performers over both periods and carry a significantly higher weighting in the growth index.

Large cap stocks outperformed small cap stocks for the first six months of the year, with most of that outperformance occurring in the first quarter. Small cap stocks meaningfully outperformed large cap stocks in late 2016 following the U.S. presidential election as they were thought to be the biggest beneficiaries of the new administration's policy proposals. Large cap stocks regained much of that lost ground in the first quarter as investors reassessed the likelihood that the new administration's policies would be implemented in a timely manner.

Portfolio Review

The composite generated a 1.4% return for the second quarter, compared to a 2.5% return for the Russell 2000 Index and a 0.7% return for the Russell 2000 Value Index. Year to date, the composite is up 2.2%, versus 5.0% for the Russell 2000 Index and 0.5% for the Russell 2000 Value Index. Our clients' portfolios are constructed to own stocks with the best combination of value and earnings growth. Therefore, it does not own the fastest growing small cap stocks (which typically carry high P/Es) that make up a portion of the core Russell 2000 Index. When growth stocks significantly outperform, as they have so far in 2017, performing well relative to the core index is challenging. At the same time, because we do incorporate a growth component into our investment philosophy, our clients' portfolios tend to perform better than the value benchmark when growth stocks outperform.

The composite underperformed the Russell 2000 Index for the second quarter and first six months of the year. Although sector allocation was essentially neutral, weightings in certain subsectors adversely impacted relative performance. Within the consumer discretionary sector, our clients' portfolios were overweight the poor performing retail subsector and underweight the strong performing consumer services subsector. In addition, a low weighting in the strong performing biotech subsector of the healthcare sector also detracted from performance.

The composite outperformed the Russell 2000 Value Index during the second quarter and year to date due primarily to sector allocation. Lack of exposure to the poor performing energy sector and an overweight in the strong performing industrials sector contributed to relative performance vs. the small cap value benchmark.

The information technology sector was the biggest contributor to the composite's absolute performance for the second quarter and year to date due to its heavy weighting in our clients' portfolios and solid absolute price performance. WNS (Holdings) Limited, a business process outsourcing firm, posted solid gains after delivering better than expected earnings results and providing an upbeat outlook. WNS has significant exposure to customers in Great Britain and the stock suffered a sharp decline in mid-2016 following the Brexit vote. Our analysis indicated that the company would continue to grow earnings despite Brexit-related impacts so we added to our position at that time. This is a good example of how we take advantage of "headline risk," that is, the tendency for market participants to react to macro events instead of digging deeper into company specific fundamentals.

The materials sector of our clients' portfolios also performed well, posting solid absolute and relative returns. Ferro Corporation, a specialty chemicals producer, performed well, reflecting the company's transition away from commodities to more value-added products.

The financials sector detracted most from the composite's second quarter performance due primarily to weakness at Greenhill & Co., Inc., an independent investment bank. Greenhill's first quarter earnings disappointed as several large deals closed after the quarter ended. We believe the company's outlook remains solid despite the near term earnings setback.

The consumer discretionary sector detracted most from the composite's absolute performance for the first six months of the year due primarily to our relatively heavy weighting in retail stocks. Given the headwinds facing traditional brick-and-mortar retailers, we have reduced our exposure there to only our highest conviction holdings.

Outlook

The risk/reward for equities appears balanced. Valuations are towards the higher end of their historical range, creating risk to the downside if earnings disappoint. However, the outlook for earnings is favorable, leading to the potential for stock price gains if those expectations are achieved.

Small cap stocks continue to trade towards the high end of their historical valuation range. We believe current valuations are in part a reflection of the low returns available on alternative investments like bonds in a low interest rate environment. However, the Federal Reserve has begun to gradually raise their target interest rate, believing that the economy is healthy enough to withstand a less accommodative monetary policy. If the Fed's move results in meaningfully higher interest rates throughout the economy, equity valuations may not look as attractive relative to bonds.

Current valuations are also supported by an improved outlook for corporate profits. The backdrop is favorable for earnings growth, as indicated by the Fed's confidence that the economy is healthy enough to absorb gradual rate hikes. In addition, economic activity outside the U.S. is expected to accelerate this year after a lackluster 2016. The modest earnings recession experienced by U.S. companies beginning in early 2015 appears to have ended in the second half of last year, providing positive momentum entering this year.

We believe the fundamentals of the companies in our clients' portfolios remain solid and their valuations are attractive relative to the typical small cap company. Because of our focus on finding the best combination of above average earnings growth and below average valuations, our clients' portfolios tend to be somewhat more economically sensitive than their benchmarks. We believe our clients' portfolios are well positioned to take advantage if earnings improve as we expect.

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Note: Portfolio holdings are subject to change and are not a recommendation to buy individual securities. The views expressed are those of Skyline Asset Management, L.P. and are subject to change. The composite's performance is gross of fees. Gross returns do not reflect the deduction of investment advisory fees or expenses and therefore the client's return will be reduced by the advisory fees and any other expenses it may incur. For example, a separately managed client portfolio, which earned 15% per annum for ten years, would result in a cumulative return of 304.6% before the investment advisory fee of 1% and expenses and 270.7% net of such fees and expenses. Current investment advisory fees are described in Part 2 of Skyline's Form ADV.
Sources: CNBC LLC; Jefferies LLC; Nasdaq Stock Market; Needham & Company, LLC; Northcoast Research Holdings, LLC; Sandler O'Neill + Partners, L.P.; Seeking Alpha; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.